71-1376

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Supreme Court, U. S.
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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1971

No. _____

GEOGHEGAN & MATHIS, INC. - - Petitioner

versus

COMMISSIONER OF INTERNAL REVENUE - - - - - - - Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1971

No. _____

GEOGHEGAN & MATHIS, INC. - - - - *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE - *Respondent*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner, Geoghegan & Mathis, Inc., prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Sixth Circuit (its Case Number 71-1439) entered in the above case on January 28, 1972.

OPINIONS BELOW

The opinion of the United States Tax Court is reported at 55 T.C. 672 (1971). The opinion of the Court of Appeals for the Sixth Circuit is reported at 453 F. 2d 1324. A copy of the opinion of the Tax Court appears in the appendix, *infra,* at pages 19-26, and a copy of the opinion of the Court of Appeals for the Sixth Circuit appears in the appendix at pages 27-33.

JURISDICTION

The judgment of the Court of Appeals for the Sixth Circuit was made and entered on January 28, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Petitioner, an open pit quarry operator, paid a utility company for the cost of relocating that portion of a gas pipeline which transversed petitioner's mineral tract and impeded the advancement of the quarry mining face. The original location of the pipeline was within an easement granted to the utility company by petitioner's predecessor-in-title. Removal of the pipeline was accompanied by a grant by petitioner to the utility company of a new easement around the perimeter of its property for the relocated pipeline and a simultaneous release to petitioner of the original easement across its tract. In computing its Federal income tax petitioner deducted from its gross income the cost of the pipeline relocation as a mine development expense under Section 616(a) of the Internal Revenue Code of 1954. Alternatively, it claimed the payment deductible as an ordinary and necessary business expense under Code Section 162(a), as supplemented by the "receding face" doctrine applicable to mining expenditures.

The respondent disallowed the deduction, asserting that the expenditure was part of the capital cost of land.

The Tax Court upheld the respondent and it was affirmed by the Court of Appeals.

The questions presented are:

1. May a mining operator deduct as an "expenditure for the development of a mine or other natural deposit" under Section 616(a) of the Internal Revenue Code of 1954 the cost of removing an artificial obstruction to its ongoing mining process, where the expenditure is made to gain access to minerals which it already owned, and when the removal of the obstruction is accompanied by the release of an easement dominant to the mining tract?

2. Under such circumstances, and where removal of the obstruction is necessitated solely by reason of the prior recession of the mining face as a result of the mining process, may the expenditure be deducted as an ordinary and necessary business expense of mining?

These questions are of particular significance to the mining industry. But a question of much broader significance to the administration of the tax law, not expressly met in the opinions of the courts below, is also presented:

3. Where a payment is entirely made for and appropriated to an object or function which, when considered alone, would render the payment wholly deductible for Federal income tax purposes, is the payment rendered non-deductible solely by reason of the concomitant receipt by the taxpayer of a capital benefit, encompassed within the total transaction, to which separate contractual consideration is allocable?

STATUTES AND REGULATIONS INVOLVED

The principal statutes involved are Section 616(a) and Section 162(a) of the Internal Revenue Code of 1954. Section 616(a) provides as follows:

> "(In General)—Except as provided in subsection (b), there shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures."

The full text of Section 616 is set forth in the appendix, *infra,* at page 34.

Section 162(a) provides in pertinent part as follows:

> "(In General)—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *"

Also involved are Treasury Regulations, Sections 1.616-1 (1960) and 1.612-2 (1960), both of which are reprinted in the appendix, respectively, at pages 35-37 and 37-38.

STATEMENT

All of the facts and exhibits were stipulated to the Tax Court.

The business of the petitioner is the operation of limestone quarries. In 1959, petitioner purchased the fee simple title to a tract of land near Bardstown, Kentucky. Prior to petitioner's purchase, it had been determined that the tract contained limestone in commercially marketable quantities and that such limestone lay under the entire surface of the tract.

An eight inch gas pipeline diagonally crossed the central portion of the tract approximately thirty inches below the surface. The owner of the pipeline, Louisville Gas & Electric Company, possessed a perpetual easement, granted in 1944 by petitioner's predecessors-in-title, for the purpose of constructing and maintaining the pipeline. The easement carried with it no mineral rights, and reserved to the fee owner full use of the premises within the right-of-way boundaries, except for the purposes granted to the utility.

In 1959, the petitioner began extracting limestone on the western boundary of the tract, using the open pit or open face method of mining. The operation progressed from the west side of the property toward the east and northeast sides. Operations were not initially affected by the pipeline, but by late 1963 the mining face had been brought near the pipeline, and it became apparent that the existing mining face could no longer be advanced unless the pipeline was relocated.

Petitioner entered into negotiations with the utility company to accomplish the pipeline's relocation and an agreement was reached whereby petitioner agreed to bear the actual cost of physically removing and rerouting the pipeline around the eastern and northern boundaries of its tract. Separately, but as a part of the overall arrangement, a "Grant and Release of Easement" was executed on January 16, 1964 by petitioner and the utility company which granted to the utility company a new easement for the location of its pipeline, and simultaneously released to petitioner the existing right-of-way through the center of its tract. The relocation work was performed during 1964, and on December 4, 1964 the utility company invoiced petitioner for the cost of the work in the amount of $14,682.78, which petitioner paid on December 28, 1964. After relocation of the pipeline, petitioner extended the mine face through normal operations to the eastern portion of the tract.

In its Federal income tax return for its taxable year ended February 28, 1965, petitioner claimed a deduction for the payment of $14,682.78 as a development expense under Section 616(a) of the Internal Revenue Code of 1954. The deduction was disallowed by the respondent on the ground that the expenditure represented the cost of acquisition of land.

The respondent's determination was timely appealed to the United States Tax Court, whose jurisdiction was based on Internal Revenue Code Sections 6214 and 7442.

Upon fully stipulated facts and exhibits, the Tax Court concluded that the payment by petitioner was inseparable for tax purposes from the release of the easement, notwithstanding the fact that the entire payment was solely for the cost of the physical relocation of the pipeline. The Tax Court considered the payment to be for a right of access to petitioner's limestone deposits—a right which the Tax Court regarded as equivalent to an interest in land, and hence not deductible either as a mine development expense or as an ordinary and necessary business expense (55 T.C. at p. ——; appx. at p. 25).

The Court of Appeals affirmed, finding that —

> "[T]he right of access to the minerals was impaired by the right of the utility company to maintain its pipeline through the center of the tract. The purchase of this right and the concomitant relocation of the pipeline by the appellant was an essential element in the acquisition of the right of access to the minerals, and therefore must be treated as part of the cost of the mineral rights themselves." 453 F. 2d 1324, 1327-1328, appx., p. 32.

REASONS FOR GRANTING THE WRIT

I. The Court of Appeals for the Sixth Circuit has rendered a decision important to the administration of the Internal Revenue Code which is in direct conflict with the decision of the United States Court of Claims in *Kennecott Copper Corporation* v. *United States*, 347 F. 2d 275 (Ct. Cl. 1965), *nonacq.*, Rev. Rul. 67-35, 1967-1 Cum. Bul. 159.

By reason of the conclusions of the courts below that the claimed deductible payment was inseparable from the release of the easement, notwithstanding that no part of such payment was assigned by the parties to such purpose, the decision below was acknowledged by both the Tax Court (55 T.C. at p. 676; appx., p. 24) and the Court of Appeals (453 F. 2d at p. 1328; appx., p. 31) to be in conflict with the *Kennecott Copper Corporation* decision. In the *Kennecott Copper Corporation* case, the Court of Claims held that where the primary purpose and the result of an expenditure were to gain physical access by extension of a producing mine to minerals owned by the taxpayer, the expenditure was a deductible development expense, notwithstanding the fact that the means of such access, acquired by the claimed expenditure, were rights with common law real property characteristics.

The facts in *Kennecott* may be condensed as follows:

Kennecott owned and operated an open pit copper mine. The mouth of the excavation had been extended by previous operations until it was close to property owned by a neighbor, United States Smelting, Refining and Mining Co. (USSRMCO). Kennecott thereupon acquired stripping, dumping and transport rights as to USSRMCO's tracts in order to continue expansion of the mouth of its excavation and thus gain access to the copper deposits upon its own property. The sole consideration moving from Kennecott to USSRMCO in exchange for the access rights was an undertaking to provide substitute facilities (physical

structures) for those of USSMRCO that would be destroyed in the process. The cost to Kennecott of such facilities, supplied during the seven-year period 1949-1955, was $14,500,000.00, which Kennecott amortized and deducted over the nine-year period of 1949-1957 against income from its copper deposits which were benefited by the rights Kennecott had acquired.

The Court of Claims first found that the expenditures were not currently deductible as "receding face" expenditures under the tests set forth by the then applicable Treasury Regulation,[1] because acquisition of the surface rights was not necessitated "solely because of the recession of the working faces of the mine." 347 F. 2d at pp. 296-297.

The court then considered whether the expenditures were otherwise deductible as ordinary and necessary business expenses to be deducted ratably as deferred expenses, or, with respect to years after 1950, deductible currently as "development expenditures" under Section 23(cc) of the Internal Revenue Code of 1939. It concluded that the deduction depended upon whether the expenditures constituted "development costs."

In an exhaustive opinion, the Court of Claims undertook to ascertain the meaning of the term "development costs" in a context which would distinguish such costs from capital outlays subject to depletion.

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[1]Regulations 111, Section 29.23(m)—15(a) and (b), relating to the Internal Revenue Code of 1939. The "receding face" doctrine is reflected in the current Treasury Regulations, Sec. 1.612-2.

It took notice of the difficulty of this task:

> "The phrase 'development costs' entered the language of the tax law as descriptive of costs incurred in bringing a mine into production. Now, there is recognition of development costs incurred after the mine has reached the producing stage. Preparatory development costs have been fairly well defined. The development costs of a producing mine have not been so well defined. * * *
>
> "[T]he cases which bear on the issues here presented involve many borderline conclusions in their appraisal of particular situations. Instances are not uncommon of oversimplification, of classification by fiat, or of a gloss of added emphasis to compensate for uncertainty. The result is that attempts to harmonize the decisions often prove futile." 347 F. 2d at p. 282.

The court concluded that the crucial characterization it had to make was between the cost of *access* to minerals already owned and the cost of acquisition of such minerals. It held that the surface rights which Kennecott paid for, tested by this criterion, were deductible development costs.

The Court of Appeals in the instant case held that the Court of Claims had placed undue emphasis on the concept of *access* in defining the term "development expenditure." It found the "commonly accepted" definition of "development expense" to be "that *activity* necessary to make a deposit accessible for mining" (emphasis supplied), relying upon legislative history and *Santa Fe Pacific Railroad Company* v. *United States*, 378 F. 2d 72, 76 (7th Cir. 1967) and

Amherst Coal Company v. *United States,* 295 F. Supp. 421, 441 (S.D. W. Va. 1969) aff'd *per curiam,* Fourth Circuit Nos. 14,257-14,260, Filed 1-19-71; 27 AFTR 2d 71-460, 71-1 USTC par. 9223. Since the Court did not regard petitioner's expenditure as one for *"activity,"* it concluded there could be no deduction.

Undoubtedly, "activity" has been involved in most of the cases dealing with mine development costs, but it is by no means settled that activity is the exclusive prerequisite for deductibility. The legislative history[2] which the Court of Appeals found consistent with its definition does not contain a definition of development expenditures. The change in the law with which the various committee reports were concerned dealt principally, not with the essential nature of development expenditures, but rather with the time they were to become deductible as measured in terms of the stage of life of the mine.

Neither *Santa Fe Pacific Railroad Co.* nor *Amherst Coal Co.* cited meaningful authority for the proposition that the "activity" definition was "commonly accepted". Moreover, in *Estate of Alexia D.O. DeBie*

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[2]Committee reports accompanying Section 23(cc) of the Internal Revenue Code of 1939, added by Section 309(a), Revenue Act of 1951, 65 Stat. 452, 486-487, which was the predecessor section of I.R.C. Section 616(a). The Court of Appeals cited H. Rept. No. 586 (Ways and Means Committee), 82nd Cong., 1st Sess., pp. 30-31, 107-108, 1951-2 C.B. 357, 379-380, 434-435; S. Rept. No. 781, Part 1 (Finance Committee), 82nd Cong. 1st Sess., pp. 43-45, 1951-2 C.B. 458, 489-490; S. Rept. No. 781, Part 2 (Finance Committee Supp. Rept.), 82nd Cong., 1st Sess., pp. 21-22, 1951-2 C.B. 545, 558-560; H. Rept. No. 1213 (Conference Committee), 82nd Cong., 1st Sess., p. 71, 1951-2 C.B. 622, 625-626; Report of Staff of Joint Committee on Internal Revenue Taxation (October, 1951), pp. 25-26, 1951-2 C.B. 287, 306-307.

56 T.C. 876, the Tax Court surmised (footnote 4) that there was considerable doubt within the mining industry itself as to the precise meaning of the terms "development" and "exploration" as applied to mine expenditures.

The issue here presented is likely to be one of recurring significance. With a fixed amount of land and an increasing national demand for minerals of all kinds, mining operators who must extend existing mines will with increasing frequency find it necessary to negotiate with and compensate possessors of conflicting easements, licenses and other less-than-fee, nonmineral interests. For example, see Rev. Rul. 66-170, 1966-1 Cum. Bul. 159, where a fact situation similar to the instant case is posed.

II. Petitioner in the courts below alternatively asserted that its expenditure was deductible as an ordinary and necessary business expense under I.R.C. Section 162, as supplemented by the "receding face" doctrine applicable to mines. The "receding face" doctrine is recognized by Treasury Regulations, Section 1.612-2 (1960) (appx., p. 24) which, however, limits deductibility under the doctrine to expenditures for qualifying *equipment*. The remaining requirements of the regulations are (a) that the expenditures, made "solely because of the recession of the working faces of the mine," must be necessary to maintain (as distinguished from attain) normal output; and (b) that the expenditures do not increase the value of the mine, or the cost of production of mineral units, or

"represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made. * * *"

The rationale of the doctrine was enunciated in *Marsh Fork Coal Co.* v. *Lucas,* 42 F. 2d 83 (4th Cir., 1930):

> "We think it is but fair to charge against the coal which has been mined the expense which its removal has necessitated. * * * To capitalize the expenditure made to *maintain normal output* means that the cost of removal is pyramided against the coal further back in the mine, with the result that the coal nearest the headhouse will appear to have been mined at an abnormal profit and that farther back at a loss." 42 F. 2d at p. 85. (Emphasis supplied.)

Petitioner's expenditure, obviously made to maintain normal output, would qualify under the criteria of the regulation cited except that it concededly was not for the acquisition of equipment. While most of the cases involved the receding face doctrine have been concerned with expenditures for equipment,[3] there appears to be no sound reason for limiting the doctrine to equipment expense, absent any statutory restriction. In this case the Tax Court and the Court of Appeals, having concluded that petitioner's expenditure represented the cost of real property, found it unnecessary to further consider petitioner's alternative assertion of the receding face doctrine. If certiorari is granted,

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[3]Many examples of qualifying expenses are set forth in *U. S. Gypsum Company* v. *U. S.*, 206 F. Supp. 744, at 750 (D.C.N.D. Ill., 1962).

we will ask this Court to consider applicability of the receding face doctrine if for any reason it finds that the claimed expenditure, though not representing the cost of a real property interest, is nevertheless unqualified as a deduction for development expense under Section 616. In this event, the Court may settle the issue as to whether the "receding face doctrine" is restricted to expenditures for equipment.

III. If the petitioner's expenditure, made solely for the removal and relocation of the pipe line, had been considered separately for Federal income tax purposes from the grant and release of easements entered into by petitioner with the utility company, then its expenditure unquestionably would have been held to have been one for "activity necessary to make a deposit accessible for mining" (the definition of "development" preferred by the Court of Appeals) and there would have been no conflict with the *Kennecott Copper Corp.* decision. The fully stipulated facts (record, Stipulation of Facts, pars. 10, 11) and exhibits (Exhibits 6, 7, and 8) make it clear that no portion of the pecuniary payment was allocated or attributable to the release of the easement, and indeed was determined precisely and only by the cost, established after the work was accomplished, of relocating the pipeline.

Nevertheless, both the Tax Court and the Court of Appeals concluded that the payment must be clothed with the tax attributes of an easement because that was the legal interest, or right, pursuant to which the original pipeline was constructed and maintained, and because the release of the easement and the pipe removal were viewed as part of the same transaction.

We do not contend that the pipeline relocation and the granting and releasing of easements were entirely independent transactions. We do contend that the relation between the easement release and the pipeline removal should not preclude deduction of the cost of the pipeline removal where it is clearly authorized by the applicable Code section. The cost of the pipeline removal was clearly attributable only to the activity of relocation. Adequate consideration—the grant of the new easement, for which petitioner claimed no deduction—was present to support the release to petitioner of the original easement.

The parties here intended that an easement be exchanged for an easement, and that money be paid for the activity of removing a pipeline. Whether one element would have occurred without the other begs the question. If either exchange was "ancillary" to the other, the negotiations of the parties (Exhibits 6 and 7) as well as economic reality indicate that the easement exchange was of the lesser significance.

This Court has established that "the tax law deals in economic realities, not legal abstractions," *Commissioner* v. *Southwest Exploration Co.*, 350 U. S. 308, 315 (1956), and that the incidences of taxation depend upon the substance rather than the form of a transaction. *Commissioner* v. *Court Holding Co.*, 324 U. S. 331 (1945).

It has also been stated that "[W]here part of a transaction calls for one tax treatment and another for a different kind, allocation is demanded." *Commis-*

sioner v. *Ferrer,* 304 F. 2d 125, 135 (2nd Cir. 1964), citing *Helvering* v. *Taylor,* 293 U. S. 507 (1935).

For example, where the sale of a business occurs, it is well established that allocation by the parties of the total consideration between goodwill, a capital item, and a covenant not to compete, an income item, will be respected for tax purposes if the allocation is supported by economic reality. *Ullman* v. *Commissioner,* 264 F. 2d 305 (2nd Cir. 1959); *Barran* v. *Commissioner,* 334 F. 2d 58 (5th Cir. 1964). The standard applied is whether genuine business reasons sustain the allocation. *Schulz* v. *Commissioner,* 294 F. 2d 52 (9th Cir. 1961).

Except for the sale-of-business situation, however, there is a need for further guidance from this Court as to the tax separability of transactions which encompass both deductible and non-deductible expense elements.

We respectfully submit that the hearing of this case will afford this Court the opportunity to promulgate clarifying standards for the separability of transactions in respect of deductible and non-deductible expenses which would facilitate the resolution at administrative levels of many tax controversies where this general problem exists.

CONCLUSION

For the reasons stated above, it is respectfully prayed that a writ of certiorari be granted to review the judgment of the United States Court of Appeals for the Sixth Circuit.

Respectfully submitted,

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TAX COURT OF THE UNITED STATES

Docket No. 1295-68

GEOGHEGAN & MATHIS, INC. - - - - *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE - - *Respondent*

55 T. C. No. 68
Filed January 27, 1971
[Headnote Omitted]

OPINION

TANNENWALD, *Judge:* Respondent determined deficiencies in the income taxes of petitioner as follows:

Fiscal year ending	Deficiency
February 28, 1963	$ 7,924.65
February 29, 1964	6,469.53
February 28, 1965	15,917.53

The parties have disposed of all the issues except that relating to a deduction in 1965 under section 616(a) or section 162(a)[1] for a certain claimed development expenditure relating to petitioner's limestone quarry.

All of the facts have been stipulated and are found accordingly.

Petitioner, Geoghegan & Mathis, Inc., is a Kentucky corporation whose principal place of business, at the time of

[1] All references are to the Internal Revenue Code of 1954 unless otherwise specified.

filing the petition herein, was Bardstown, Kentucky. Its return for the taxable year ending February 28, 1965 was timely filed with the district director of internal revenue, Louisville, Kentucky.

Petitioner's principal business is the operation of limestone quarries. In 1959, petitioner purchased the fee title to a tract of land near Bardstown, Kentucky. Prior to petitioner's purchase, it had been determined that the tract contained limestone in commercially marketable quantities and that such limestone lay under the entire surface of the tract.

A gas pipeline crossed the central portion of the tract purchased by petitioner. The owner of the pipeline, Louisville Gas & Electric Co. (hereinafter the utility company) possessed a perpetual right-of-way or easement across the tract for the purpose of constructing and maintaining this pipeline. Petitioner's title to the tract was specifically made subject to this right-of-way. The right-of-way agreement contained the following clause:

> The said grantors, their heirs, personal representatives and assigns, shall have the right fully to use and enjoy the said premises except for the purposes herein granted to said grantee, his heirs, personal representatives and assigns.

In 1959, petitioner began extracting the limestone on the western boundary of the tract by using the open pit method. This method utilized a vertical mining face and a horizontal mining floor. The original face and floor were established by excavation. Subsequently, the method by which the limestone was removed involved essentially two steps. First, the earth overburden which covered the limestone formations was removed by excavation. Second, the limestone was removed from the face of the mine by blasting and drilling.

As more limestone was extracted, petitioner's mining operations necessarily came closer to the pipeline. The existence of the pipeline and the right-of-way impeded further mining operations. The existing mining face could no longer be advanced unless the pipeline was removed.

Petitioner's officers negotiated with the utility company concerning relocation of the pipeline. On January 15, 1964, an agreement was reached whereby petitioner granted the utility company a new easement or right-of-way around the northern and eastern edges of the tract and the utility company surrendered its old right-of-way or easement to petitioner. As part of the arrangement, petitioner also agreed to bear the costs of relocating the pipeline on the new easement or right-of-way.

During petitioner's taxable year ending on February 28, 1965, the pipeline was relocated at a cost to petitioner of $14,682.78, which petitioner deducted as a development expenditure in addition to its deduction for depletion. Petitioner's continuing mining operations subsequently extended the mining face into that portion of the tract which was originally northeast of the earlier location of the pipeline.

Resolution of the issue in this case turns upon whether the cost to petitioner of relocating the utility company's pipeline represents, as petitioner contends, a development expenditure deductible under section 616(a)[2] or an ordi-

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[2]SEC. 616. DEVELOPMENT EXPENDITURES.

(a) In General.— * * * [T]here shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures.

(*Footnote continued on following page.*)

nary and necessary business expense deductible under section 162(a) or, as respondent contends, a capital item chargeable to petitioner's depletion account. In essence, petitioner argues that the expenditure added nothing to its full rights to the limestone stemming from its fee ownership of the land, was a mere cost of exploiting its pre-existing rights, and was consequently a legitimate development expenditure. Respondent counters with the argument that the expenditure was an essential element in the acquisition by petitioner of a right of access, that it represented the cost of obtaining a property right, that realistically it should be treated as part of the cost of the mineral rights themselves, and that therefore it is not a deductible expense but rather a depletable item. We agree with respondent.

The thrust of petitioner's argument with respect to section 616(a) is that, since the purpose of its arrangements with the utility company was to obtain access to the limestone with respect to which it already owned all mineral rights, its expenditure for relocation of the pipeline falls within the same category as expenditures for roads with respect to an open pit mine (*Amherst Coal Company* v. *United States*, 295 F. Supp. 421 (S.D. W.Va. 1969)) or shafts and tunnels with respect to subsurface mining (see *United States Gypsum Company* v. *United States*, 206 F. Supp. 744, 753 (N.D. Ill. 1962); S. Rept. No. 781, 82nd

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The predecessor of section 616(a) was section 23(cc) of the 1939 Internal Revenue Code, added by section 309(a), Revenue Act of 1951, 65 Stat. 452, 486-487. See S. Rept. No. 781, Part 2, 82nd Cong., 1st Sess., pp. 21-22, 1951-2 C.B. 545, 559, for a clear statement of the purposes of section 23(cc). See also H. Rept. No. 586 (Ways and Means Committee), 82nd Cong., 1st Sess., pp. 30-31, 107-108, 1951-2 C.B. 357, 379-380, 434-435; S. Rept. No. 781, Part 1 (Finance Committee), 82nd Cong., 1st Sess., pp. 43-45, 1951-2 C.B. 458, 489-490; S. Rept. No. 781, Part 2 (Finance Committee Supp. Rept.), 82nd Cong., 1st Sess., pp. 21-22, 1951-2 C.B. 545, 558-560; H. Rept. No. 1213 (Conference Committee), 82nd Cong., 1st Sess., p. 71, 1951-2 C.B. 622, 625-626; Report of Staff of Joint Committee on Internal Revenue Taxation (Oct. 1951), pp. 25-26, 1951-2 C.B. 287, 306-307.

Cong., 1st Sess.). Compare *Clear Fork Coal Company* v. *Commissioner*, 229 F. 2d 638, 643-644 (C.A. 6, 1956), reversing 22 T.C. 1075 (1954); *Repplier Coal Co.* v. *Commissioner*, 140 F. 2d 554 (C.A. 3, 1944), affirming a Memorandum Opinion of this Court; *Alsted Coal Co.* v. *Yoke*, 104 F. Supp. 606 (N.D. W.Va. 1952), affd. 200 F. 2d 766 (C.A. 4, 1952); *Guanacevi Mining Co.* v. *Commissioner*, 127 F. 2d 49 (C.A. 9, 1942), affirming 43 B.T.A. 517 (1941). See also *Commissioner* v. *H. E. Harman Coal Corp.*, 200 F. 2d 415, 418 (C.A. 4, 1952). In so arguing, petitioner relies heavily on *Kennecott Copper Corporation* v. *United States*, 347 F. 2d 275 (Ct. Cl. 1965).

It cannot be gainsaid that petitioner had, prior to the arrangement with the utility company, been vested with fee title to the minerals themselves. But the fact remains that the *right* of access to those minerals was impaired by the right of the utility company to maintain its gas pipeline in perpetuity by virtue of the right-of-way agreement—a right which had sufficient attributes to be considered an interest in property. Cf. *Inaja Land Co., Ltd.*, 9 T.C. 727 (1947); *H. L. Scales*, 10 B.T.A. 1024 (1928). Compare also *Ebb B. Nay*, 19 T.C. 114 (1952); *Louis W. Ray*, 18 T.C. 438, 441 (1952), aff'd 210 F. 2d 390 (C.A. 5, 1954). Petitioner seeks to avoid this hard fact by pointing to the provision in the right-of-way agreement that "[t]he said grantors, their heirs, personal representatives and assigns, shall have the right fully to use and enjoy the said premises." In so doing, however, petitioner conveniently ignores the further qualifying language in that same provision, which adds "except for the purposes herein granted to said grantee, his heirs, personal representatives and assigns." Such qualifying language clearly impairs the prior reservation of full use and enjoyment.

We think it clear that by its arrangements with the utility company petitioner eliminated a property interest in favor of the latter and acquired a *right* of access to the

minerals which it did not previously have. Whatever may be the limits of the deductibility of expenditures for exploiting rights of access in the area of open pit mining,[3] either as development expenses under section 616 or as ordinary and necessary expenses under the so-called receding face doctrine (see section 1.612-2, Income Tax Regs.),[4] we think that payments for *rights of access* should not be included therein.[5] Compare *Commissioner* v. *Southwest Exploration Co.*, 350 U. S. 308 (1956). Such payments in reality represented an additional investment in petitioner's limestone deposit and, in our opinion, do not fall within the scope of "activity necessary to make a deposit accessible for mining." See *Santa Fe Pacific Railroad Company* v. *United States*, 378 F. 2d 72, 76 (C.A. 7, 1967); *Amherst Coal Company* v. *United States, supra*, 295 F. Supp. at 441. The payment was for a *right* to engage in an activity, not an expense of carrying out the activity as such.

We recognize that the approach of *Kennecott Copper Corporation* v. *United States, supra*, supports a contrary view. But, in our judgment, the Court of Claims in that case failed to distinguish between a payment for a right of

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[3]The legislative history, as well as the judicial and administrative treatment of the problem from as early as the Revenue Act of 1918, indicates that determinations were guided mainly by the experiences of subsurface mining operations. See Alexander and Grant, "Mine Development and Exploration Expenditures," 8 Tax L. Rev. 401 (May 1952). See also *Kennecott Copper Corporation* v. *United States*, 347 F. 2d 275, 286-312 (Ct. Cl. 1965); Levy and Simonds, "Capitalization of Mining Expenditures," 26 Taxes 203 (March 148). Cf. *Enterprise Coal Co.* v. *Phillips*, 12 F. Supp. 49 (M.D. Pa. 1935) (discussion of accounting for purchase of additional property), affirmed per curiam, 84 F. 2d 565 (C.A. 3, 1936).

[4]Compare Rev. Rul. 67-169, 1967-1 C.B. 159; Rev. Rul. 67-35, 1967-1 C.B. 159; Rev. Rul. 66-170, 1966-1 C.B. 159.

[5]We are bolstered in our conclusion that a distinction should be drawn between expenditures for rights of access and those simply to exploit rights of access by the cases holding that a portion of the cost of land not necessary for mining a deposit can and should be allocated to the basis for determining cost depletion. *Beaver Dam Coal Company* v. *United States*, 370 F. 2d 414 (C.A. 6, 1966); *Potts Run Coal Co.*, 19 B.T.A. 1, 5 (1930).

access and a payment to exploit an unimpaired right of access which concededly exists. Moreover, by emphasizing the purpose of the payor as distinguished from the objective fact of what was obtained for the payment, the Court of Claims seems to open the door to the deductibility under section 616 of the costs of creeping acquisitions of surface rights necessary to continue an open pit mining operation—a result which would do violence to the proper concept of the term "development expenditures." Cf. *Denise Coal Co.*, 29 T.C. 528, 550-551 (1957); *Manchester Coal Co.*, 24 B.T.A. 577 (1931). To the extent that the *Kennecott* case may be read to reach the conclusion urged by petitioner herein, we respectfully decline to follow it.

Perhaps in anticipation of our focusing on its acquisition of a right of access in the form of an interest in property represented by the outstanding right-of-way, petitioner has, in the alternative, sought to dissect the arrangements between it and the utility company. Thus, it contends that the consideration for the release of the right-of-way was solely the furnishing by petitioner of a substitute right-of-way and that, petitioner having thus obtained the unimpaired right of access, the payment of the cost of relocating the gas pipeline was simply an expenditure for exploiting its right of access. We disagree. We think it completely unrealistic to conclude that the utility company bargained its right-of-way exclusively for another right-of-way. It is clear to us that the bargain was the existing right-of-way and pipeline for another right-of-way *and* relocation of that pipeline. Nuances in language contained in the written documents and the lapse of time between the release of the right-of-way and the grant of the new right-of-way, on the one hand, and the formal undertaking to pay the relocation costs, on the other, are not persuasive. The arrangements between the petitioner and the utility company encompassed a single transaction. Cf. *Kennecott*

Copper Corporation v. *United States, supra,* 347 F. 2d at pp. 280, 283.

The foregoing rationale is equally dispositive of petitioner's further claim that such expenditures constitute an ordinary and necessary business expense under section 162(a). Compare *Mt. Morris Drive-In Theatre Co.,* 25 T.C. 272 (1955), affirmed per curiam, 238 F. 2d 85 (C.A. 6, 1956); *Hotel Sulgrave, Inc.,* 21 T.C. 619 (1954). In this connection, we note, without expressing an opinion with respect thereto, that petitioner offered no evidence as to its prior practice or the practice of the industry with respect to expenditures such as are involved herein. Compare *Kennecott Copper Corporation* v. *United States, supra,* 347 F. 2d at 300-305; see *Welch* v. *Helvering,* 290 U. S. 111, 113-115 (1933).

Decision will be entered under rule 50.

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 71-1439

GEOGHEGAN & MATHIS, INC., - - *Petitioner-Appellant,*

v.

COMMISSIONER OF INTERNAL REVENUE, - - - - - *Respondent-Appellee.*

APPEAL FROM THE UNITED STATES TAX COURT.

Decided and Filed January 28, 1972.

OPINION OF COURT OF APPEALS

Before: EDWARDS and PECK, Circuit Judges, and McALLISTER, Senior Circuit Judge.

PECK, Circuit Judge. This is an appeal by the taxpayer, Geoghegan & Mathis, Inc., of Bardstown, Kentucky, to review a decision of the United States Tax Court which is reported at 55 T.C. 672 (1971). The only issue for determination concerns the deductibility for federal income tax purposes of $14,682.78 paid by the taxpayer-appellant during its taxable year ended February 28, 1965.

The appellant is a Kentucky corporation whose principal place of business is at Bardstown, Kentucky, and whose principal business is the operation of limestone quarries. In 1959, the appellant purchased the fee simple title to a tract of land near Bardstown. Prior to appellant's purchase, it had been determined that the tract contained lime-

stone in commercially marketable quantities and that such limestone lay under the entire surface of the tract.

An eight inch gas pipeline diagonally crossed the central portion of the tract approximately thirty inches below the surface. The owner of the pipeline, the Louisville Gas & Electric Company, possessed a perpetual easement for the purpose of constructing and maintaining this pipeline.

In 1959, the appellant began extracting the limestone on the western boundary of the tract, using the open-pit or open-face method of mining. The operation progressed from the west side of the property toward the east and northeast side. Mining operations were not initially affected by the pipeline, but by late 1963 the mining face had been brought near the pipeline. As the vertical face of the pit moved with the mining process, it necessarily came closer to the existing pipeline right of way. Ultimately the existing mining face could no longer be advanced unless the pipeline was removed.

Appellant's officers therefore entered into negotiations with the utility company concerning relocation of the easement and pipeline. A "Grant and Release of Easement" was executed on January 16, 1964, by the appellant and the utility company which released the existing right of way through the center of the tract and granted to the utility company a new easement around the eastern and northern boundaries of the tract. As part of the arrangement, the appellant agreed to bear the costs of relocating the pipeline within the new right of way. The relocation work was performed during 1964, and on December 4, 1964, the utility company invoiced the appellant for the cost of relocation in the amount of $14,682.78, which appellant paid on December 28, 1964. After relocation of the pipeline, the mine face was extended to the eastern portion of the tract.

In its federal income tax return for its taxable year ended February 28, 1965, the appellant claimed a deduction for the payment of $14,682.78 as a development expense

under § 616 (a) of the Internal Revenue Code of 1954.[1] The claimed deduction was disallowed by the Commissioner of Internal Revenue on the ground that the amount represented the cost of acquisition of land. All of the facts and exhibits were fully stipulated, and the Tax Court concluded that the payment in question represented the cost of a real property interest and as such could not be deducted, and upheld the Commissioner's determination of disallowance.

The appellant's main contention at trial and on appeal is that the sum expended for relocation of the pipeline and right of way was entirely deductible that year as a development expenditure as provided by § 616(a) of the Internal Revenue Code of 1954. The Commissioner's position is that the expenditure was not a development expense within the scope of this section but was a part of the capital cost of mineral rights to the limestone.

Section 616(a) allows a current deduction from taxable income for any expenditures incurred for the development of a mine if paid or incurred after the existence of minerals in commercially marketable quantities has been disclosed. There is no question that appellant's expenditures for relocation were incurred after the existence of minerals in commercially marketable quantities had been disclosed. Thus the only question here is whether the payment was "for the development of a mine or other natural deposit," as required before a deduction may be taken under § 616(a).

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[1]Section 616(a) of the Internal Revenue Code of 1954 provides:

> "Except as provided in subsection (b), there shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures."

Because "development" expenditures are not defined in the statute, an examination of the legislative history and judicial interpretations of this section is necessary to ascertain the intended scope of the term. Prior to 1951, mining development expenses were deductible during the "production" stage of a mining operation. Such expenses were considered as currently deductible operating expenses (or if extraordinary, deductible ratably as the benefited minerals were mined and sold). However, development expenses incurred after discovery of minerals, but during the mine's "development" stage, were required to be capitalized and were recoverable only through deductions for depletion. E.g., see *Clear Fork Coal Co.* v. *Commissioner*, 229 F. 2d 638 (6th Cir. 1956). In 1951, section 23(cc) of the Internal Revenue Code of 1939 was enacted to provide that all "development" expenses incurred after commercially marketable quantities of minerals were disclosed became currently deductible, whether incurred during the development or production stage of operation. The legislative history[2] of this enactment is relevant in that it clarifies what congress and the industry understood by the term "development expense."

The Committee reports accompanying Section 23(cc) indicate specific legislative intent to provide statutory assurance that mining operators using the percentage depletion

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[2]Section 23(ee) [sic] of the Internal Revenue Code of 1939, added by section 309(a), Revenue Act of 1951, 65 Stat. 452, 486-487 was the predecessor of section 616(a) of the 1954 Code. *See* S. Rept. No. 781, Part 2, 82nd Cong., 1st Sess., pp. 21-22, 1951-2 C.B. 545, 559, for a clear statement of the purposes of section 23(cc). See also H. Rept. No. 586 (Ways and Means Committee), 82nd Cong., 1st Sess., pp. 30-31, 107-108, 1951-2 C.B. 357, 379-380, 434-435; S. Rept. No. 781, Part 1 (Finance Committee), 82nd Cong., 1st Sess., pp. 43-45, 1951-2 C.B. 458, 489-490; S. Rept. No. 781, Part 2 (Finance Committee Supp. Rept.), 82nd Cong., 1st Sess., pp. 21-22, 1951-2 C.B. 545, 558-560; H. Rept. No. 1213 (Conference Committee), 82nd Cong., 1st. Sess., p. 71, 1951-2 C.B. 622, 625-626; Report of Staff of Joint Committee on Internal Revenue Taxation (Oct. 1951), pp. 25-26, 1951-2 C.B. 387, 306-307.

method should be allowed a full and separate deduction for development expenditures. From a study of the legislative history of this section and of the cases arising under it we find that the commonly accepted definition of development expense, "that activity necessary to make a deposit accessible for mining," to be consistent with the legislative intent and with virtually all the decisions treating this code section. (E.g.: *Santa Fe Pacific Railroad Co.* v. *United States*, 378 F. 2d 72, 76 (7th Cir. 1967), *Amherst Coal Co.* v. *United States*, 295 F. Supp. 421, 441 (S.D. W.Va. 1969).)

The appellant relies predominately upon the decision of the Court of Claims in *Kennecott Copper Corp.* v. *United States*, 347 F. 2d 275 (Ct. Cl. 1965). The Commissioner's position is that *Kennecott* was wrongly decided and should not be followed. The Tax Court recognized that *Kennecott* "supports a contrary view," and declined to follow it. 55 T.C. at 676.

In *Kennecott*, the taxpayer owned and operated a copper mine using the "open pit" method of stripping. From time to time it became necessary to widen the pit, causing the outside circumference of the mine to become larger and necessitating the moving of facilities and outbuildings further and further from the center. When the outer circle reached one boundary of Kennecott's property, negotiations were made with the neighboring owner, United States Smelting Refining and Mining Company (USSRMCO), with the resulting agreement that Kennecott would receive easements, rights and privileges over, on and under various surface tracts to strip, dump and leach (a process which obtains ore from waste earth). Kennecott received rights to only some of the minerals under the surface and obligated itself to replace all of USSRMCO's facilities that would be destroyed in the process. There was no conveyance of any fee interest to Kennecott. In consideration for all of the rights acquired, Kennecott paid USSRMCO about 14.5 million dollars, which Kennecott amortized over a nine-year

period as an ordinary and necessary expense of mining. The Commissioner contended that the expenditures made by Kennecott to acquire the various surface rights from USSRMCO should have been capitalized and returned to Kennecott through annual depletion charges, rather than being deducted as an ordinary expense.

The Court of Claims concluded that where surface rights were acquired in order to provide access to minerals of a producing mine, the expense of acquiring them was more related to their exploitation than to their acquisition, and therefore that Kennecott's expenses could be deducted as "development expenses". 347 F. 2d at 312.

In permitting Kennecott to amortize its $14.5 million expense in full over a brief period of years, the Court of Claims permitted the amortization of the full amount notwithstanding the finding that some part of the payment was for all the other rights acquired, including the main right to strip the surface, payment for which would admittedly be capitalized and recovered by depletion. More importantly, while recognizing the distinction "between the cost of acquiring the surface rights and the cost of exploiting them," the Court allowed Kennecott to amortize the replacement costs as being for "acquisition," not for exploitation of the surface. 457 F. 2d at 285.

The appellant owned the fee title to all the minerals in the tract of land in question. When it purchased the land the company was aware of the dominant estate owned by the gas company for its pipeline. The appellant was also aware of the fact that access could not be had to the limestone without relocation of the pipeline; therefore, the right of access to the minerals was impaired by the right of the utility company to maintain its pipeline through the center of the tract. The purchase of this right and the concomitant relocation of the pipeline by the appellant was an essential element in the acquisition of the right of access to the minerals, and therefore must be treated as part of the cost of

the mineral rights themselves. It is a depletable item, and not deductible under § 616(a).

We decline to follow the *Kennecott* decision because we feel that the Court of Claims failed to distinguish between the payment for a right of access to minerals and the payment for exploitation of minerals to which a right of access already exists. There is no "activity" involved in the former, and thus expenses for payment of a right of access should not be deducted as development expenses.

The Tax Court's holding that the cost of obtaining the right to acquire access to minerals was not currently deductible is in accord with the decision of this Court in *Beaver Dam Coal Co.* v. *United States*, 370 F. 2d 414 (6th Cir. 1966). In that case, the owner of coal rights below the surface separately purchased surface rights so that operating companies could strip to reach the coal. The owner was often forced to purchase much more surface area than he needed at a price higher than the non-coal area would normally command. This Court held that the company should add to its depletable cost basis of the minerals not only the per acre cost of the surface to be destroyed, but also the premium paid for the non-coal acres in excess of the fair market value. Thus, the cost to the company of the land it did not need was for acquisition of the right to strip mine the desired surface, which is the right to obtain access to the coal. This expenditure was therefore properly capitalized and recovered through depletion. 370 F. 2d at 417.

For the reasons hereinabove set forth, and for those contained in the opinion of the Tax Court, 55 T.C. 672 (1971), *supra*, the judgment of that court is affirmed.

INTERNAL REVENUE CODE OF 1954, SECTION 616

DEVELOPMENT EXPENDITURES

Sec. 616. (a) In General.—Except as provided in subsection (b), there shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures.

(b) Election of Taxpayer.—At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary or his delegate, expenditures described in subsection (a) paid or incurred during the taxable year shall be treated as deferred expenses and shall be deductible on a ratable basis as the units of produced ores or minerals benefited by such expenditures are sold. In the case of such expenditures paid or incurred during the development stage of the mine or deposit, the election shall apply only with respect to the excess of such expenditures during the taxable year over the net receipts during the taxable year from the ores or minerals produced from such mine or deposit. The election under this subsection, if made, must be for the total amount of such expenditures, or the total amount of such excess, as the case may be, with respect to the mine or deposit, and shall be binding for such taxable year.

(c) Adjusted Basis of Mine or Deposit.—The amount of expenditures which are treated under subsection (b) as deferred expenses shall be taken into account in computing the adjusted basis of the mine or deposit, except that such

amount, and the adjustments to basis provided in section 1016(a)(9), shall be disregarded in determining the adjusted basis of the property for the purpose of computing a deduction for depletion under section 611.

TREASURY REG. § 1.616-1 (1960)

Development expenditures—(a) *General rule.* Section 616 prescribes rules for treating expenditures paid or incurred during the taxable year by the taxpayer for the development of a mine or other natural deposit (other than an oil or gas well). Development expenditures under section 616 are those which are made after such time when, in consideration of all the facts and circumstances (including actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. Under section 616(a), a taxpayer is allowed a deduction for development expenditures whether or not such expenditures are made in the development or production stage of the mine or other natural deposit. Under section 616(b), the taxpayer may elect to defer development expenditures made in the development or producing stage and to deduct such expenditures ratably as the minerals or ores benefited are sold. While the mine or other natural deposit is in the development stage, the election applies only to that portion of the development expenditures which is in excess of net receipts from the mine or other natural deposit. See § 1.616-2 for rules with respect to the election to defer. It is not necessary that the taxpayer incur the development costs directly. He may engage a contractor to make the expenditures on his behalf.

(b) *Expenditures to which section 616 is not applicable.* (1) Section 616 is not applicable to development expenditures which are deductible for the taxable year under any other provision of the internal revenue laws.

(2) Section 616 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowances for depreciation of such improvements which are used in the development of ores or minerals are considered development expenditures under section 616. If such improvements are used only in part for development during a taxable year, an allocable portion of the allowance for depreciation shall be treated as a development expenditure.

(3) Section 616 is applicable to development expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired. The expenditure attributable to the remaining fractional share shall be considered as part of the cost of his acquired interest and shall be capitalized and recovered through depletion allowances. For example, taxpayer A owns mineral leases on undeveloped mineral lands. A agrees to convey an undivided three-fourths (¾) interest in such leases to B, provided B will pay all of the expenditures incurred during the development stage of the deposits on these leases. B may deduct three-fourths (¾) of such amount under section 616, but shall treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) The provisions of section 616 do not apply to costs of development paid or incurred by a prior owner which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Such provisions apply only to costs paid or incurred by the taxpayer for development undertaken directly or through contract by the taxpayer. See, however, sections 381(a) and 381(c)(10) for special rules with respect to deferred development expenditures in certain corporate acquisitions.

(c) *Mine or other natural deposit.* Section 616 has reference to expenditures made for the development of a mine

or other natural deposit. Within an aggregated property, as that term is defined in section 614(b) and (c), or within a single tract or parcel of land, there may be more than one mine or other natural deposit. Where a property, as determined under section 614, contains more than one mine or other natural deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines or deposits, and may defer under section 616(b) the development expenditures made with respect to another of such mines or deposits. Where there is more than one mine with respect to a single underlying deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines, and may defer under section 616(b) the development expenditures made with respect to another of such mines. The taxpayer must treat consistently all development expenditures with respect to each such mine or other natural deposit in a taxable year. The taxpayer must make a separate determination of the units of minerals or ores benefited in a mine or other natural deposit (regardless of the computation of the depletion allowance) in order that deferred expenditures with respect to such mine or deposit may be deducted on a ratable basis. See paragraph (f) of § 1.616-2.

TREASURY REG. § 1.612-2 (1960)

Allowable capital additions in case of mines.—(a) *In general.* Expenditures for improvements and for replacements, not including expenditures for ordinary and necessary maintenance and repairs, shall ordinarily be charged to capital account recoverable through depreciation deductions. Expenditures for equipment (including its installation and housing) and for replacements thereof, which are necessary to maintain the normal output solely because of the recession of the working faces of the mine and which—

(1) Do not increase the value of the mine, or

(2) Do not decrease the cost of production of mineral units, or

(3) Do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made

shall be deducted as ordinary and necessary business expenses.

(b) *Special rule.* For special provisions applicable to treatment of expenditures for certain exploration and development costs (other than for the acquisition, restoration, or betterment of improvements) with respect to minerals other than oil or gas, see sections 615 and 616 and the regulations thereunder.

In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-1376

GEOGHEGAN & MATHIS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 19-26) is reported at 55 T.C. 672. The opinion of the court of appeals (Pet. App. 27-33) is reported at 453 F. 2d 1324.

JURISDICTION

The judgment of the court of appeals was entered on January 28, 1972. The petition for a writ of certiorari was filed on April 25, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court of appeals erred in holding that petitioner's $14,682.78 payment for relocation of a utility company's pipeline and right of way across petitioner's mineral tract was a capital cost of obtaining

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the right of access to mineral deposits, and thus neither a development expenditure deductible under Section 616(a) of the Internal Revenue Code of 1954 nor an ordinary and necessary business expense deductible under Section 162(a) of the Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and Regulations are set forth in the petition and its Appendix (pp. 4, 34–38).

STATEMENT

In 1959, the petitioner, an operator of limestone quarries in Kentucky, purchased a fee interest in a tract of land under which commercially marketable quantities of limestone were known to exist. This purchase was subject to existing easements and restrictions, including a utility company's perpetual easement across the central portion of the tract for the construction and maintenance of a gas pipeline. (Pet. App. 27–28.)

From 1959, petitioner mined the tract, using the open pit method. As the vertical face of the pit moved in an eastern direction with the mining process, it came closer to the pipeline easement and pipeline. In order to permit the continuation of mining progress, petitioner entered into negotiations with the utility company which resulted in their joint execution of a "Grant and Release of Easement" on January 16, 1964, releasing the existing easement and granting a new easement circumventing the mining area. As part of the agreement, petitioner, in December, 1964, paid the cost of relocating the pipeline within the new right of way. In its federal tax return for its

1964 taxable year, petitioner deducted the full amount of the relocation expenditure as a development expenditure under Section 616(a) of the Code. On the theory that the cost of relocating the pipeline was a depletable capital expenditure, the Commissioner of Internal Revenue disallowed the claimed expense deduction. The Tax Court upheld the disallowance, and the court of appeals affirmed. (Pet. App. 28–29, 33.)

ARGUMENT

The decision below is correct. Although there is an apparent conflict of decisions, the decisions are factually distinguishable, the decision below was correctly decided, and the issue is not of sufficient administrative importance to warrant further review by this Court.

1. The Internal Revenue Code permits mining operators such as the petitioner to recover their capitalized mining costs through reasonable annual deductions for depletion, "to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset." *Parsons* v. *Smith*, 359 U.S. 215, 220; *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81. In addition, a mining operator may, under Section 616(a), take deductions for certain "development" expenses "incurred after the existence of * * * minerals * * * has been disclosed." The petitioner's contention is that the pipeline relocation expenditure was currently deductible as a development expense, or, alternatively, as an ordinary and necessary business expense.

The expense at issue here was incurred after marketable quantities of minerals were known to exist; the only question under Section 616, therefore, is whether the expense was within the scope of the term "development" as used in that section. Upon examination of the legislative history of Section 616, both courts below correctly concluded that the petitioner's pipeline relocation cost was not within the category of expenditures intended by Congress to be deductible under that section. The predecessor of Section 616 was enacted in 1951 not to create a new category of deductible mining expenses, but rather, to codify the deduction already allowed by the Commissioner for certain expenses known in the mining industry as development expenses, and to permit such deductions during earlier stages of the mining operation than was previously permitted.[1]

The courts below correctly held that Congress, by adopting the commonly understood meaning of devel-

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[1] Section 309(a), Revenue Act of 1951, c. 521, 65 Stat. 452, 486; codified as Section 23(cc) of the Internal Revenue Code of 1939. Prior to 1951, development expenses were permitted to be deducted currently only if incurred during the "production" stage of a mine's operation. Any such expenses incurred after the discovery of minerals, but during the preliminary "development" stage of operation, were required to be capitalized and recovered only through deductions for depletion. Treasury Regulations 111 (1939 Code), Sec. 29.23(m)-15; *Clear Fork Coal Co.* v. *Commissioner*, 229 F. 2d 638 (C.A. 6). The purpose of the 1951 statutory enactment was not to alter the scope of the term "development expenditures," but, rather, to extend their deductibility into the earlier "development" stage of operation. H. Rep. No. 586, 82d Cong., 1st Sess., pp. 30, 107 (1951-2 Cum. Bull. 357, 379, 434-435); S. Rep. No. 781, 82d Cong., 1st Sess., Part 1, pp. 43-44 (1951-2 Cum. Bull. 458, 489).

opment expense, intended to authorize current deduction only of those expenses related to *activity* necessary to make a mineral accessible and not those of acquiring the *right* to carry on such activity. S. Rep. No. 781, 82d Cong., 1st Sess., Part 1, pp. 43–44 (1951–2 Cum. Bull. 458, 489).[2] Other courts have so concluded in similar cases. See, *e.g.*, *Santa Fe Pacific Railroad Co.* v. *United States*, 378 F. 2d 72, 76 (C.A. 7); and *Denise Coal Co.* v. *Commissioner*, 29 T.C. 528, 549–551, affirmed 271 F. 2d 930, 937 (C.A. 3). The facts of record in this case fully support the holding below that the expense at issue was incurred for the *right* to conduct mining operations in the area subject to the utility company's easement rather than for petitioner's *activity* in making the minerals accessible. Consequently, the expenditure was not a development expense within the meaning of Section 616.

2. Petitioner asserts that the decision of the court of appeals here is in conflict with the decision of the United States Court of Claims in *Kennecott Copper Corp.* v. *United States*, 171 Ct. Cls. 580, 347 F. 2d 275. In *Kennecott* the taxpayer used an open pit method

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[2] During the Committee hearings regarding the 1951 legislation, experts called to testify defined "development expenses" in terms such as the following (3 House Hearings before the Committee on Ways and Means on Revenue Revision of 1951, 82d Cong., 1st Sess., p. 1576):

"* * * simply advance costs of mining the deposit. They include such items as shafts, tunnels, haulage drifts, and other underground workings required for access to the ore * * *."

and (*id.*, p. 1609):

"* * * in their nature and purpose to provide the mines with facilities for mining the discovery ore body."

of coal strip-mining which required stripping in concentric circles, with the mining operation located in the center pit. Periodically, it became necessary to widen the center pit and each successive circular step, and Kennecott had frequently been required to destroy and replace its own mining facilities in the process of expanding these circles. 347 F. 2d at 302. In 1948, when the outer circle reached one boundary of Kennecott's property, agreement was reached with the neighboring owner, USSRMCO, to permit continued expansion in that direction. These agreements granted various rights to Kennecott, including the right to strip the surface, but not the fee interest in the adjoining land. As consideration for the granting of these surface rights, Kennecott agreed to pay for replacement of all of USSRMCO's buildings and other facilities destroyed during the expanding mining process, and in fact paid about $14.5 million for these replacements from 1949 through 1955. 347 F. 2d at 276, 278–279, 282. Kennecott did not allocate this amount among the various rights acquired, but treated it as spent entirely for replacing the destroyed facilities. For tax purposes, Kennecott amortized the replacement costs over a nine-year period, 1949–1957, claiming that the cost was deductible in those years as ordinary and necessary expenses of mining under Section 23(a)(1)(A) of the Internal Revenue Code of 1939 and Section 162 of the 1954 Code.[3] 347 F. 2d at 276–278. Alternatively, Kennecott claimed the ex-

[3] Kennecott chose to deduct the expense ratably over the nine year estimated period for the stripping operation on USSRMCO's property. 347 F. 2d at 285.

penses were deductible as development expenditures of a producing mine for 1949 and 1950 (under the pre-1951 statute and regulations, see *supra,* p. 4, note 1), and as development expenditures for later years under the 1951 statutory provision now found in Section 616. Although the Court of Claims noted that "[D]evelopment costs ordinarily relate to active operations rather than access * * *," 347 F. 2d at 299, it concluded, in our view erroneously, that under the particular circumstances, the cost of acquisition of the neighboring surface rights was, at least for one of the years involved, a deductible development expense.

Although there appears to be a conflict in principle between the instant case and *Kennecott,* it is not clear that the Court of Claims would have decided the instant case in taxpayer's favor. The court noted in *Kennecott* that the Internal Revenue Service had never required *Kennecott* to capitalize similar costs for destruction and replacement of its facilities during the early years of its mining operation. Though the court recognized that the Service was not bound by its prior actions, it found "persuasive support" for taxpayer's position in the prior practice. 347 F. 2d at 303–304. Furthermore, the court in *Kennecott* based its interpretation of the term "development expenditures" in part upon an analogy between Kennecott's expense in acquiring access to adjoining property and the cost of an easement for building a mine access road, which it felt would be deductible as part of the cost of constructing the road. 347 F. 2d at 307–308. The Court of Claims has subsequently

recognized that the cost of acquiring an easement is presumptively a capital expenditure subject to recovery through depreciation or, in this case, depletion. *Panhandle Eastern Pipeline Co.* v. *United States,* 408 F. 2d 690; see also *Casey* v. *United States,* 72 U.S.T.C., par. 9419, May 12, 1972.

3. Petitioner asserts (Pet. 12–13) alternatively that it should be permitted to deduct the pipeline relocation costs under Section 162 as an ordinary and necessary business expense, pursuant to the "receding face" doctrine described in Treasury Regulations Section 1.612–2 (Pet. App. 37–38). Under this Regulation, certain *equipment* expenditures necessary to maintain normal output solely because of the recession of the working face of a mine are deductible as ordinary and necessary business expenses. Petitioner admits that since the expense claimed here was not for equipment, it does not qualify for the deduction according to the terms of the Regulations. Petitioner seeks, however, to invalidate the Commissioner's interpretation of the scope of the receding face doctrine to the extent that it excludes the petitioner's expenditure (Pet. App. 13–14). Having failed to question the validity of Treasury Regulations Sec. 1.612–2 in the courts below, petitioner may not do so in the petition for certiorari. *Lawn* v. *United States,* 355 U.S. 339, 362, n. 16.[4] In any

[4] In its brief in the court of appeals (Br. 32), petitioner, referring to the Regulation, stated: "We do not directly rely on that regulation here, as it appears to relate only to expenditures for *equipment* * * *."

event, the Regulation, which recognizes a limited exception to the general rule that capital expenses for mining equipment must be added to the depletable basis pursuant to Section 612, is reasonable and consistent with the statutory scheme, and, accordingly, should be upheld. *United States* v. *Correll,* 389 U.S. 299. Furthermore, while petitioner's expense may have been necessary, it cannot be said to have been an ordinary expense of petitioner's operation, as was found to be the case in *Kennecott, supra.*

4. In spite of the apparent conflict between this case and the decision of the Court of Claims in *Kennecott,* this case is not of substantial present administrative importance. Only one other case is now pending involving this issue—*Cushing Stone Co.* v. *United States,* Ct. Cls. No. 419–70. In that case, the Court of Claims will have an opportunity to reconsider its position in light of the contrary views of the Tax Court and the Sixth Circuit expressed in this litigation, and in light of its recent holding that the cost of obtaining an easement is ordinarily a capital expenditure. See *supra,* pp. 7–8.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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